Summary

Insurance-linked securities (ILS) is an alternative asset class offering investors the potential for attractive risk-adjusted returns and desirable diversification benefits. This primer describes a number of key aspects of the asset class from the perspective of capital market investors, including:

- A definition of ILS
- How the asset class has performed
- A look at the various ILS structures
- How ILS is managed within a portfolio context

Diversification does not assure a profit or protect against loss in a declining market.

What are insurance-linked securities?

Insurance-linked securities (ILS) are investments whose performance depends upon the occurrence of pre-specified catastrophic events. The events, though statistically unlikely (for example: on average of 1 in 75 to 1 in 200 years), have historically been expensive to re/insurance companies when they do occur. ILS provide a way for re/insurance companies to transfer a portion of their risk and premiums to the capital markets, which allows investors to participate in the re/insurance market. The concept of re/insurers transferring risks to the capital markets gained traction following Hurricane Andrew (1992), which cost the industry $15.5 billion.

ILS investors take on the role of a re/insurance company, receiving premiums in exchange for accepting the risk of a loss. If the triggering events do not occur during the tenor of the agreement, the investor enjoys a periodic coupon payment related to insurance premiums and principal repayment at the end of the investment term. If one of the specified events occurs, all or part of the principal is used to pay insured losses and the investors’ coupon payments cease or are reduced; at maturity there is either zero or a reduced amount of principal repaid.

What are some of the typical pre-specified perils and geographical regions covered in an ILS transaction?

ILS are designed to offer reinsurance protection to the bond’s sponsor following claims from one or more natural catastrophes, such as hurricanes, earthquakes, tornadoes and winter storms. Regions that make up the bulk of the coverage are the U.S., Canada, Europe, South America, Japan, New Zealand and Australia. In addition, the regional exposure is mostly developed countries as the re/insurance industry has a low penetration in emerging markets.

Source: Swiss Re

Insurance-linked securities are subject to risks, including but not limited to, issuer (creditor) default, illiquidity, price volatility and limited transparency in reinsurance investments. See additional risk information on page 7.
What are the risk/return characteristics of ILS?

Given the nature of catastrophe insurance, characterized by low frequency and high severity events, ILS can offer higher coupon payments relative to comparably rated corporate bonds. As such, investors may expect relatively high annual returns potentially. However, given the randomness and severity of natural disasters, investors should also expect some years of sizeable losses. Portfolio level volatility is reduced by diversifying exposures across geographic region and perils. Nonetheless, we believe investors should maintain long-term time horizons when committing capital to the asset class.

The risk and return potential for ILS securities is based on the modeled frequency and severity of the insured events. Investor demand and the reinsurance industry’s need for external capital can also impact premiums. During periods of strong investor demand, the return potential may be lower. Likewise, expected returns from ILS may be higher when reinsurers have a greater need to increase their use of external capital. This typically follows a large industry loss.

The below chart shows annual returns for the Swiss Re Cat Bond Index dating back to 2002 (index inception). We show this index because it has market-based pricing and a relatively long track record. However, it does not reflect the full ILS market, because it does not include private market securities (ILS structures are described below). Catastrophe (Cat) bonds also have a higher concentration to peak zone risks (U.S. hurricane/earthquakes) than what would be included in a diversified ILS portfolio.

In terms of performance, this has been a relatively benign period of catastrophic events for cat bonds. Notable events that impacted investor returns were Hurricane Katrina (2005), the Japan earthquake and tsunami (2011) and Hurricane Sandy (2012). The 1.8% return during 2008 was below expectations in a year with limited catastrophic events. Performance was affected by supply/demand dynamics related to broader capital market volatility during the financial crisis. However, the return compared favorably to the -26.4% return for the Bank of America Merrill Lynch High Yield Bond Index during that year.

Calendar Returns for the Catastrophe Bond Market

Source: Swiss Re Cat Bond Index as of 12/31/14. Data represents past performance, which is no guarantee of future results. Data not meant to represent the performance of any Pioneer product. The Swiss Re Cat Bond Total Return Index tracks the price return and the total rate of return for U.S. dollar denominated catastrophe bonds. Insurance-linked securities are subject to risks, including but not limited to, issuer (creditor) default, illiquidity, price volatility and limited transparency in reinsurance investments.

Modeling the impact of significant historical catastrophic events on a hypothetical portfolio provides another angle for evaluating the return profile of ILS. The analysis below was produced using a widely accepted insurance industry risk analytic system, AIR Worldwide CATRADER (CATRADER). CATRADER uses sophisticated statistical analysis that incorporates the full magnitude of historic events on the current geographical area and building structures. This allows us to model the impact of past events on a current ILS portfolio.

The hypothetical portfolio analyzed had an expected mean long-term return of 10% and median expected return of 14%. The analysis incorporates 300 years of actual catastrophic events. During this time, 22 events caused modeled portfolio losses greater than 10% and as large as 65%. These loss events are accounted for in the hypothetical portfolio’s expected returns. The top five occurrences are shown in the table below. It shows the potential loss impact to the overall industry and the hypothetical ILS portfolio. The largest event occurred over 200 years ago in 1812. A key take away is the asset class offers an attractive return potential. However, the unpredictable nature of catastrophic events requires a long-term time horizon to absorb losses, which can potentially be high.
**Portfolio Modeled Exposure to Historical Events**

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
<th>Peril</th>
<th>Modeled Industry Loss ($ bn)</th>
<th>Modeled Portfolio Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1812</td>
<td>New Madrid, MO</td>
<td>U.S. Earthquake</td>
<td>143.9</td>
<td>-65.4%</td>
</tr>
<tr>
<td>1906</td>
<td>San Francisco, CA</td>
<td>U.S. Earthquake</td>
<td>103.3</td>
<td>-53.1%</td>
</tr>
<tr>
<td>1938</td>
<td>NoName4 (New England)</td>
<td>U.S. Hurricane</td>
<td>40.6</td>
<td>-39.5%</td>
</tr>
<tr>
<td>1707</td>
<td>Hoei Scenario 1</td>
<td>Japan Hurricane</td>
<td>154.9</td>
<td>-22.8%</td>
</tr>
<tr>
<td>1923</td>
<td>Taisho Kanto</td>
<td>Japan Earthquake</td>
<td>64.2</td>
<td>-22.7%</td>
</tr>
</tbody>
</table>

As shown in the chart below, ILS’s positive attributes have led to strong risk-adjusted performance relative to many other asset classes. ILS has had higher absolute returns than U.S. high yield and equity over the past 13 years with significantly lower volatility.

**Over the 13-year period ending April 30, 2015, ILS offered higher returns with lower risk than many other asset classes**

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Source: Morningstar 4/30/15. Data represents past performance, which does not guarantee future results. Data is not meant to represent the performance of any Pioneer product. The **JPM EMBI Plus TR Index** represents the performance of emerging market bonds. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. ILS represented by the **Swiss Re Cat Bond Total Return Index**, which tracks the price return and the total rate of return for U.S. dollar denominated catastrophe bonds. U.S. Stocks represented by the **S&P 500 Index**, a commonly used measure of the U.S. Stock Market. Hedge Funds represented by the **DB Hedge Fund Total Return Index**, an asset-weighted hedge fund index. Commodities represented by **Bloomberg Commodity Total Return Index**. US Aggregate Bonds represented by the **Barclays U.S. Aggregate Index**. High Yield Corporate Bonds represented by the **Barclays U.S. Aggregate Bond Index** and the **BofA ML U.S. High Yield Master II Index**, respectively. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

One of the most appealing aspects of ILS is its potential diversification properties. By definition, performance is driven by random meteorological or geophysical catastrophic events, which leads to a very low correlation to traditional financial market investments. The table below shows the correlation of the Swiss Re Cat Bond Index to other asset classes during the past 13-years. It is important to point out that we are using cat bonds as a proxy for the full ILS market. The modestly positive correlation was related to the 2008 financial crisis. Because cat bonds are tradable assets, broader capital market supply and demand dynamics increased their correlation to other financial assets. We believe a portfolio that includes private structures would have an even lower correlation to other asset classes.

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3 **Standard deviation** is a statistical measure of historical volatility.

4 **Correlation** – The degree to which assets or asset class prices have moved in relation to one another. Correlation ranges from -1 (always moving in opposite directions) through 0 (never move together) to 1 (always move together).
Asset Class Primer | Insurance-Linked Securities

Over the 13-year period ending April 30, 2015, Low Correlation to Traditional Asset Classes

<table>
<thead>
<tr>
<th></th>
<th>ILS</th>
<th>U.S. Equities</th>
<th>Hedge Investments</th>
<th>Commodities</th>
<th>U.S. Aggregate Investment Grade Bonds</th>
<th>U.S. High Yield Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Equities</td>
<td>0.20</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hedge Investments</td>
<td>0.11</td>
<td>0.12</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodities</td>
<td>0.20</td>
<td>0.38</td>
<td>0.08</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Aggregate Investment Grade Bonds</td>
<td>0.19</td>
<td>-0.08</td>
<td>0.07</td>
<td>0.11</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>U.S. High Yield Bonds</td>
<td>0.28</td>
<td>0.69</td>
<td>0.12</td>
<td>0.43</td>
<td>0.20</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Data represents past performance. Past performance does not guarantee future results. Source: Pioneer Investments, Data as of 4/30/15. ILS represented by the Swiss Re Cat Bond Total Return Index, which tracks the price return and the total rate of return for U.S. dollar denominated catastrophe bonds. U.S. Stocks represented by the S&P 500 Index, a commonly used measure of the U.S. Stock Market. Hedge Funds represented by the Credit Suisse Hedge Fund Total Return Index, an asset-weighted hedge fund index. Commodities represented by Bloomberg Commodity Total Return Index. U.S. Aggregate Investment Grade Bonds represented by the Barclays U.S. Aggregate Index. High Yield Corporate Bonds represented by the BofA ML U.S. High Yield Master II Index. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

How may ILS fit within an investor’s aggregate portfolio?

We believe including ILS within a broader asset allocation can have powerful diversification benefits and total return potential. As discussed, ILS portfolio returns are not determined by economic factors such as GDP growth, interest rates or corporate profitability. Rather, performance is driven by the occurrence of low-frequency, high-severity natural disasters such as earthquakes and hurricanes. This is a key distinguishing feature, which has resulted in a very low correlation to other asset classes. The return profile and liquidity of the asset class does require a long-term investment horizon. Given these characteristics, we believe ILS may fit well within the alternative asset class portion of an investor’s portfolio.

What types of ILS structures exist and what are their characteristics?

The following are four common types of ILS formats.

**Catastrophe (CAT) Bonds** are the most well-known ILS format. CAT Bonds are issued as tradable securities, which allow them to have an active secondary market. As such, cat bonds are used widely by traditional fixed income investors. They provide a precise level of protection above a certain threshold. They also contain triggers with defined conditions, which must be reached before losses accumulate. For example, a cat bond could cover Florida hurricane damage of a specific re/insurer between $3 billion and $3.3 billion. Alternatively, a cat bond could be structured to cover multiple events such as a Florida hurricane and an Australia cyclone.

**Industry Loss Warranties (ILW’s)** are a private, customizable reinsurance contracts through which a re/insurance company can reduce or hedge risk exposure. The payout is based on industry wide losses rather than company specific experience. For example, an ILW could be triggered if industry wide Florida hurricane losses exceed $15 billion for a given event. A benefit to investors is they are not reliant on the quality of the underwriting and claims management process of the individual insurer.

**Collateralized Reinsurance** are private, customizable reinsurance contracts that insurance companies use to reinsure losses related to company specific claims (indemnity triggers). Collateralized reinsurance allows investors to take on the role of a reinsurance company. This product is increasingly popular as it allows the cedent (reinsurance protection buyer) to use capital markets as an additional source of reinsurance protection. Collateralized reinsurance provides investors broad diversification across geographical region and peril.
**Quota Share** (also known as Reinsurance Sidecars) are different in structure from the ILS described above in a couple important ways. First, quota share allow investors to participate side-by-side with the reinsurer and share in the profit or losses of its book of business. Investors do need to be vigilant with the pieces of business being shared in order to avoid “adverse selection” or the risk of participating in unfavorable “cherry picked” risks. If structured correctly, quota share better aligns investor and cedent interests than other forms of ILS. They are highly diversified across region and peril with losses gradually paid out of the structure as they occur. Quota share offer annual liquidity and typically include one to two year terms. These structures gained popularity following large catastrophic events such as Hurricane Katrina because it allowed the re/insurance industry to recapitalize itself quickly.

Each format has its distinguishing features. However, it is important to realize there are also overlapping characteristics across the formats. Key distinguishing features include:

**Binary vs. gradual loss payouts:** The severity of principal loss following catastrophic events differs across structures. It is based on the level of regional and peril diversification and the size of loss layer within the structure. Structures with more gradual provide greater diversification. Binary structures can be wiped out quickly if the pre-specified event occurs. These structures allow for more targeted risk exposures.

**Indemnity vs. non-indemnity payout triggers:** The mechanism that quantifies the loss magnitude following events can be based on re/insurance company specific experience (indemnity) or more general non-indemnity based triggers. Non-indemnity triggers include industry wide loss experience, parametric (e.g. wind speed and path, earthquake location, magnitude and depth), or statistical based modeled losses. Indemnity based triggers expose investors to a specific re/insurance company’s underwriting and claim management operations, which should be considered in the security selection process.

**Active Secondary Market:** ILS are offered in tradable or private structures. As such, the level of secondary market transferability varies. Private structures typically offer potentially higher premiums compared to tradable instruments with similar risk to compensate for the lack of liquidity.

The below table summarizes the key features of four common ILS structures:

<table>
<thead>
<tr>
<th>ILS Structure</th>
<th>Binary or Gradual Payout</th>
<th>Indemnity or Non-Indemnity</th>
<th>Active Secondary Market</th>
<th>Term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catastrophe Bonds</td>
<td>Binary</td>
<td>Both</td>
<td>Yes</td>
<td>Multi-Year</td>
</tr>
<tr>
<td>Industry Loss Warranties</td>
<td>Binary</td>
<td>Non-Indemnity</td>
<td>No</td>
<td>1-Year or less</td>
</tr>
<tr>
<td>Collateralized Re-Insurance</td>
<td>Binary</td>
<td>Indemnity</td>
<td>No</td>
<td>1-2 Year</td>
</tr>
<tr>
<td>Quota Shares</td>
<td>Gradual</td>
<td>Indemnity</td>
<td>No</td>
<td>1-2 Year</td>
</tr>
</tbody>
</table>

**Why might an investor consider active management for an ILS portfolio?**

We believe an active ILS portfolio management can add more value than a passive or beta\(^5\) approach. First, there are supply and demand factors that drive the pricing of insurance risk. The re/insurance industry has varying demand for external capital, which is related to the need to recapitalize after large claim payouts. Investor willingness to supply capital varies depending on valuations and alternative investment opportunities. A manager with sophisticated insurance risk modeling tools can evaluate a security’s premium relative to the probability of an event occurring and over or underwrite the risk accordingly. Another important component of active management is the avoidance of “adverse selection” when investing in quota share. Adverse selection is the risk that the re/insurer cherry picks less favorable risk exposures and delivers it to the capital markets. Proper deal structuring and equity and credit analysts' bottom-up understanding of the re/insurers treatment of capital market investors help mitigate adverse selection risk. Finally, we believe there are qualitative inputs into the quality of an insurance company’s underwriting and claim management process that need to be evaluated when investing in various ILS formats.

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\(^5\) **Beta** measures an investment’s sensitivity to market movements in relation to an index. A beta of 1 indicates that the security’s price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security’s price has been more volatile than the market.
How does Pioneer utilize various ILS structures within active portfolio construction context?

The ILS structures described above have different characteristics that allow active managers seek to customize a portfolio based on market conditions and risk/return objectives. Pioneer’s portfolio construction approach seeks to balance the trade-offs of liquidity, risk layering and diversification. For example, when risk is priced attractively for specific perils (e.g. Florida hurricane) we might reduce diversification to benefit from the attractive Florida hurricane premium while also increasing liquidity to take advantage of cedents needing to pay more to off-load risks. Conversely, if premium levels are low across perils we might increase diversification and reduce liquidity to capture the illiquidity premium.

Quota shares form the core of the portfolio as they provide diversified risk exposures across peril and region while also lacking liquidity. Cat bonds are liquid instruments that allow us to be more nimble. They also provide precise exposure that allows us to customize portfolio risks. The trade-off with cat bonds is they offer lower yields. Collateralized reinsurance also allows for customized portfolio risk exposures. The key benefit is they allow us to express a view of the quality of a cedent’s underwriting and claim management process given they’re typically offered with an indemnity trigger. Finally, ILW’s allow us to access specific risks while not being exposed to the cedent’s underwriting operations.
A Word about Risk

Insurance-linked securities may include event-linked bonds (also known as insurance-linked bonds or catastrophe bonds). The return of principal and the payment of interest on event-linked bonds are contingent on the non-occurrence of a predefined “trigger” event that leads to physical or economic loss, such as a hurricane or an aerospace catastrophe. Event-linked bonds may expose the Fund to other risks, including, but not limited to, issuer (credit) default, adverse regulatory or jurisdictional interpretations and adverse tax consequences. The Fund may also invest in structured reinsurance investments or similar instruments structured to comprise a portion of a reinsurer’s catastrophe-oriented business (known as “quota share” instruments or “reinsurance sidecars”). Investors participate in the premiums and losses associated with these underlying contracts, into which the Fund has limited transparency. The size of the ILS market may change over time, which may limit the availability of ILS for investment. The availability of ILS in the secondary market may also be limited. Certain securities, including ILS, structured reinsurance investments and derivatives, may be impossible or difficult to purchase, sell, or unwind. Such securities and derivatives also may be difficult to value. The values of Fund holdings may go up or down, due to market conditions, inflation, changes in interest or currency rates and lack of liquidity in the bond market. Investments in high yield or lower-rated securities are subject to greater-than-average price volatility, illiquidity, and possibility of default. When interest rates rise, the prices of fixed income securities in the Fund will generally fall. Conversely, when interest rates fall, the prices of fixed income securities will generally rise. Investments in the Fund are subject to possible loss due to the financial failure of issuers of underlying securities and their inability to meet their debt obligations. Prepayment risk is the chance that an issuer may exercise its right to prepay its security, if falling interest rates prompt the issuer to do so. Forced to reinvest the unanticipated proceeds at lower interest rates, the Fund would experience a decline in income and lose the opportunity for additional price appreciation. The Fund may invest in floating rate loans and similar instruments which may be illiquid or less liquid than other investments. The value of any collateral can decline or be insufficient to meet the issuer's obligations. The securities issued by U.S. Government-sponsored entities (e.g., FNMA, Freddie Mac) are neither guaranteed nor issued by the U.S. Government. The Fund may use derivatives, such as swaps, inverse floating rate obligations and others, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on the Fund’s performance. Derivatives may have a leveraging effect. Investing in foreign and/or emerging market securities involves risks relating to interest rates, currency exchange rates, and economic and political conditions. These risks may increase share price volatility. There is no assurance that these and other strategies used by the Fund will be successful.
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